IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1732

In the Matter of

QUANTUM DEVELOPMENT CORPORATION,

Debtor.

FIRST NATIONAL CITY BANK,

Petitioner,

v.

AMERICAN FIDELITY FIRE INSURANCE CO.,
CHARLES JOY, RECEIVER
CHARLES TAIT, TEMPORARY RECEIVER,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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May 27, 1976

INDEX

CASES

STATUTES

OTHER AUTHORITIES

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Citibank, N.A. (formerly known as First National City Bank) petitions for a writ of certiorari to review the decision of the United States Court of Appeals for the Third Circuit which affirmed, on different grounds, a decision of the United States District Court of the Virgin Islands, Division of St. Croix, Christiansted Jurisdiction, directing that American Fidelity Fire Insurance Co. recover amounts claimed by it from Citibank.

Opinions Below

The opinion of the court of appeals (Appendix A) is not reported. The opinion of the district court (Appendix B) is reported at 397 F.Supp. 329 (D. V.I. 1975).

Jurisdiction

The judgment of the court of appeals was entered March 24, 1976. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Question Presented

Shall a bank, in which bankruptcy funds are deposited and which has repaid the deposit to the bankruptcy receiver, be subjected to absolute liability for subsequent misappropriation of such funds by the bankruptcy receiver, solely by reason of the fact that the branch office of the bank which accepted the deposit had not formally been designated as an official depository of bankruptcy funds?

Statute Involved

The statute involved is the Bankruptcy Act of 1898, as amended, specifically sections 47 and 61, 11 U.S.C. §§ 75 and 101 (Appendix C).

Statement

Petitioner, Citibank, a national banking association, received a deposit at its branch in St. Croix, Virgin Islands, from a duly appointed receiver in bankruptcy who had been directed by the bankruptcy court to deposit the fund in a bank. Neither Citibank's St. Croix branch nor any other bank in the Virgin Islands was an officially designated depository of bankruptcy funds. Upon the deposit's

maturity, it was transferred to a bank in Miami at the request of the receiver, who subsequently absconded with the fund.

Plaintiff below, the American Fidelity Fire Insurance Company, which had issued a performance bond on a construction project undertaken by the bankrupt, commenced the action below to recover from Citibank the funds misappropriated by the receiver. The district court, sitting as a bankruptcy court, held Citibank liable. On appeal to the United States Court of Appeals for the Third Circuit, the decision of the district court was affirmed on grounds differing from and unrelated to those expounded by the lower court. Subsequently, Citibank's petition for rehearing and suggestion for rehearing *en banc* was denied by the Third Circuit.

The facts are simple and undisputed.

At all relevant times, Charles R. Joy ("Joy") was the duly appointed receiver in bankruptcy of Quantum Development Corporation, a company formerly engaged in the construction of housing projects in St. Croix, Virgin Islands.

The district court, sitting as a bankruptcy court, issued an order directing the receiver to deposit certain funds in an interest-bearing bank account. At the time of that order neither Citibank's St. Croix branch nor any other bank in the Virgin Islands had been officially designated as depository by that bankruptcy court. Citibank was, however, an officially designated depository in Puerto Rico and this fact was known to the judge issuing the direction.

Pursuant to the district court's order, on or about September 10, 1973, the receiver Joy appeared at Citibank's branch in St. Croix with a check in the sum of $115,211 payable to "Charles Joy, Receiver Quantum Development Corporation V.I. No. 5—1972 In Bankruptcy Pursuant to Court Order of April 13, 1973." Joy purchased a certificate

of deposit in the amount of the check, payable in 60 days. Upon maturity, the proceeds were transferred, at Joy's request, to a bank in Miami, Florida, and thereafter Joy absconded with these and other funds belonging to the bankrupt.

The reverse of the check with which Joy purchased the certificate of deposit bears the following endorsement: "Charles Joy Receiver Quantum Corp." and, just beneath that, appear the words "To be applied to CD#2747 favor Charles R. Joy."

The application for the certificate of deposit was signed by Joy in the name "Charles R. Joy", and the certificate was issued in the name "Charles R. Joy."

The district court flatly rejected plaintiff's allegation that Citibank ". . . in bad faith and with knowledge and notice of the trust impressed upon such fund . . . permitted and aided Charles Joy in the transfer of such funds beyond the jurisdiction of . . . [the District] Court." The uncontradicted evidence adduced at trial showed that Citibank had no notice whatever that Joy intended to abscond with the trust funds, and there is no suggestion that any inquiry, however searching, would have uncovered this foul purpose. The district court held:

> ". . . I do not believe the facts support either knowledge of Joy's intended breach or bad faith on the part of Citibank. . . ."

However, the district court held Citibank liable on a different theory, stating:

> "Liability is rather based on the issuance by Citibank of a CD to Joy personally, in the face of unambiguous instructions, derived from both the endorsement on the $115,211.00 check and the CD application form, to issue the certificate to Joy as a receiver of Quantum." [Citing authorities]

On appeal the Third Circuit affirmed on grounds wholly outside and unrelated to the district court's opinion and without discusion of the district court's reasoning. The court below imposed absolute liability on a bank that receives a deposit of bankruptcy funds at a branch that has not been formally designated as an official depository.

Reasons for Granting the Writ

This appeal brings to this Court for resolution: a serious conflict between the decision below and the rule of law established by decisions of other circuit courts of appeals; important federal questions as to the interpretation of the Bankruptcy Act that have not been, but should be, answered by this Court.

ARGUMENT

The decision below conflicts with decisions of two other circuit courts of appeals and involves a question of federal law of such importance that it should be decided by this Court.

I

The Interpretation of the National Bankruptcy Act on This Important Question Should Not Be Permitted to Vary Among Circuits.

The decision below is in direct conflict with the decisions of the Sixth Circuit in *Irving Trust Co.* v. *United States,* 83 F.2d 20 (6th Cir. 1936), *cert. denied* 298 U.S. 686 (1936) and the Seventh Circuit in *In Re Bogena & Williams, Albright* v. *McDermott,* 76 F.2d 950 (7th Cir. 1935). In those cases, it was held that receipt of bankruptcy funds on deposit by a bank not designated as an official depository did not cause the bank to be a trustee *ex maleficio.* In this case, the court below, conceding that its decision was no more than extrapolation from the

language of sections 47 and 61 of the Bankruptcy Act (11 U.S.C. § 75 and 101) and from the decision of the Fourth Circuit Court of Appeals in *American Surety Co.* v. *First Nat. Bank,* 141 F.2d 411 (4th Cir. 1944), *cert. denied* 322 U.S. 754 (1944), fashioned a novel and contrary rule imposing on the bank absolute liability, as a trustee *ex maleficio,* for misappropriation of funds by a bankruptcy receiver subsequent to the receiver's withdrawal of funds from another bank to which the deposit had been transferred.

The important question of a bank's duties and responsibilities with respect to deposits of bankrupt estates under the National Bankruptcy Act should not be determined by geographic happenstance. The conflict of decisions by circuit courts of appeals cannot remain unresolved.

II

The Third Circuit Improperly Assumed a Legislative Function Which, at the Very Least, Is the Province of This Court.

The appeal to the Third Circuit sought to review a decision of the District Court that disbursement of funds to the fiduciary of a bankrupt estate, who thereafter embezzled the funds, was unlawful. The panel left the propriety of that decision unresolved. Instead, it undertook to declare a novel rule of law, punitive in character, that imposes absolute liability on a bank that receives funds of a bankrupt estate on deposit at a branch office that has not been formally designated as an official depository.

The decision below explicitly recognized that "the Bankruptcy Act does not by its terms impose liability upon the . . . bank" in the circumstances of this case. *Matter of Quantum Development Corp., Debtor: American Fidelity Fire Ins. Co.* v. *Joy et al.* and *Lang et al.* v. *Bank of Nova Scotia,* Nos. 75-2050 and 2051 (3rd Cir.,

filed March 24, 1976), App. A at 9a. The Third Circuit explicitly recognized that it is "not concerned here with the liability, if any, arising from improper disbursements made by fiduciaries from estate accounts maintained in and by officially designated depositories." App. A at 9a. Nevertheless the court below imposed absolute liability as a reflection of its view of legislative policy, rather than as enforcement of a legislative act. Courts are "not free, under the guise of construction, to amend the statute . . .". *Pillsbury* v. *United Eng. Co.,* 342 U.S. 197, 199 (1952).

The decision below so far departs from the function of appellate review and the constitutional separation of judicial and legislative powers that it requires review and correction by this Court.

III

The Court Below Misapprehended the Purpose of the Bankruptcy Act That It Sought to Implement.

Putting aside the issue of judicial incursion on the legislative function, the conclusion of the court below that absolute liability is mandated to effect the Bankruptcy Act's over-all policy, which is "to safeguard estate funds for creditors", misapprehends the significance of the Act's requirement that the funds of bankrupt estates be maintained with designated depositories.

The declared purpose of that provision "is to keep safely the money of bankrupt estates, and to protect creditors against weak and insolvent banks." 3A *Collier on Bankruptcy* (14th ed.), ¶ 61.02. The designation of depositories and the requirement of a bond, as in the case of public funds, protects the bankrupt estate from the risk that the depository will be unable to repay the amounts deposited. It was not intended to, and does not, protect against the risk that a trustee will misappropriate the funds deposited. The purpose of the bonding provisions of the Act is to in-

sure that the depository bank shall be able to respond to the liabilities otherwise imposed upon it by law; it is not the purpose of the Act to impose absolute liability on a solvent and responsible depository, nor to create a windfall for creditors of the bankrupt, at the expense of a depository bank, in a case in which a fiduciary is unfaithful.

The Act deals separately and precisely with the separate concerns as to the infidelity of fiduciaries. Section 50(b), 11 U.S.C. § 78, requires that receivers and trustees be bonded. In this way, Congress specifically and explicitly requires protection for the bankrupt estate from the consequences of a breach of trust by the receiver. The loss is shifted to the bonding company which, for a fee, undertook the risk that the fiduciary might neglect or betray his trust.

In this case, the loss resulted directly and exclusively from the unlawful acts of the receiver. There is no justification in law or equity for imposing upon the defendant bank a liability it did not undertake and which was not contemplated by law.

IV

The Authorities Relied on by the Court Below Do Not Support Its Holding.

The Third Circuit cited several cases involving deposits of public funds, section 324 of the Restatement 2d of Trusts, and three cases involving deposits of bankruptcy funds. Reliance on each of these authorities was misplaced.

(a) The cases cited involving unauthorized deposits of public funds are wholly inapposite to the issue raised here.*

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* *American Surety Co.* v. *Jackson*, 24 F.2d 768 (9th Cir. 1928); *Allen* v. *United States*, 285 F. 678 (1st Cir. 1923); *Board of Comm'rs* v. *Strawn*, 157 F.49 (6th Cir. 1907); *Merchants' Nat'l Bank* v. *School Dist. No. 8*, 94 F.705 (9th Cir. 1899); *Cook* v. *Elliott*, 73 F.2d 916 (4th Cir. 1934); *Coos County* v. *Berlin Nat'l Bank*, 21 F.Supp. 523 (D. N.H. 1937).

These cases all involve unauthorized or illegal deposits of public funds by governmental officials in a bank which subsequently becomes insolvent. In such cases the public funds improperly received by the bank are impressed with a trust and may be traced upon the bank's insolvency if the bank still has sufficient assets. This effectively grants the public agency a preference in the bank's insolvency proceeding. None of the cases cited by the court below, however, even tentatively suggests that a bank which repays an unlawful deposit is liable for subsequent misappropriations of the fund by the public officer charged with the care of the fund.

(b) The court's reliance on the Restatement (Second) of Trusts § 324 (1957) is equally misplaced. The Restatement does no more than impose liability for participating in a "breach of trust" on a bank which knowingly accepts an unauthorized deposit. A bank's liability under the Restatement is only for damages flowing from the breach of trust in which it participated. Nowhere does the Restatement suggest that a bank becomes an insurer for subsequent breaches of trust by the trustee after the bank has returned the fund to the trustee.

(c) *American Surety Co.* v. *First National Bank*, 141 F.2d 411 (4th Cir. 1944) and *In Re Potell*, 53 F.2d 877 (E.D.N.Y. 1931) cited by the court below do not support the novel and punitive rule fabricated by the Third Circuit.

In *Potell* a receiver made an unauthorized deposit of bankruptcy funds in a bank. A portion of the fund was subsequently withdrawn by checks inadvertently signed by the clerk of the bankruptcy court. The bank then became insolvent and the court permitted the receiver to trace and recover the fund remaining on deposit in the hands of the receiver for the insolvent bank. No penalty was imposed on the bank and nowhere does the court suggest that the bank should be liable for the portion of the fund withdrawn on the receiver's order. *Potell*, like the public funds cases,

supra, merely holds that the general creditors of an insolvent bank should not benefit at the expense of the creditors of the bankrupt's estate from an asset which should not have been in the bank's possession.

In *American Surety Co., supra,* a bank which accepted unauthorized deposits to a trustee's personal account and then permitted withdrawals of such a nature that the bank should have known the trustee was misappropriating bankruptcy assets was found jointly liable with the trustee. The breach of trust resulting in liability to the bank was not the acceptance of an unauthorized deposit, rather it was its subsequent participation in the trustee's unauthorized withdrawal. Clearly this is not the case at bar, in which the funds were returned to the lawful receiver without even the remotest indication that the receiver was not properly performing his fiduciary duties.

V

The Court Below Wholly Disregarded Facts That Are a Part of the Record.

The sole basis for the court's imposition of absolute liability on Citibank was the assumption that the bank was not officially designated as a depository of the funds of bankrupt estates. This premise is incorrect for the following reasons:

1. It appears in the record that First National City Bank was, at the time of the deposit, designated as a depository of bankrupt estates' funds. Transcript, *Matter of Quantum Development Corp.,* April 2, 4, 1975, at 158. The Bankruptcy Judge said, on the record, that the nearest officially designated depository was First National City Bank in Puerto Rico. No separate designation of any branch in the Virgin Islands was made nor, it appears, was any Virgin Islands bank or banking office officially so designated. *Id.* These facts

were known to the Bankruptcy Judge at the time that he ordered the receiver to make the deposits in question.

Citibank is a national banking association existing under the laws of the United States which has been duly authorized to conduct a general banking business at its Head Office in New York City, and at various branches located in Puerto Rico and in the Virgin Islands. These offices are integral parts of the bank; they are not separately incorporated entities. The consequence is that, with certain exceptions not here relevant, the bank is institutionally liable for its deposits regardless of the location of the branch office at which such deposits are received. When, as here, a national banking institution has been officially designated as a depository for the funds of bankrupt estates, and is solvent and responsible for such deposits, it is a denial of due process of law to impose absolute liability for receipt of funds at an office that has not been separately and specifically designated.

2. In the circumstances, and given the admitted fact that the Bankruptcy Judge was aware (a) that First National City Bank was an officially designated depository and (b) that no Virgin Islands bank nor any Virgin Islands office of a bank organized outside the Virgin Islands had been specifically designated as an official depository, the only acceptable interpretation of the Bankruptcy Judge's direction to the receiver to deposit the funds in question in an interest-bearing account is that such direction itself constituted a designation.

3. Common sense is affronted by the proposition that a court, which has ordered a judicially appointed officer to entrust funds on deposit to a bank that will pay the best rate of interest, should hold that the bank accepting the mandated deposit is *ipso facto* guilty of

an unlawful act. In this case, the bankruptcy court, with full knowledge that no Virgin Islands bank or Virgin Islands office of any other bank had been officially designated as a depository of bankruptcy funds, explicitly ordered the receiver (by appointment of that court an officer of the court) to deposit funds of the bankrupt estate in a separate interest-bearing account, subject to claims as may be determined by the court.

The effect of the decision to which this petition is addressed is that the bank branch manager is held, at the peril of the bank, to a higher standard of legal knowledge than is the court itself!

CONCLUSION

This petition for a writ of certiorari should be granted, and the decision of the court below should be reversed.

Respectfully submitted,

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May 27, 1976

Appendix A.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 75-2050 & 75-2051

In the Matter of
QUANTUM DEVELOPMENT CORPORATION,
Debtor

AMERICAN FIDELITY FIRE INSURANCE CO.

v.

CHARLES JOY, RECEIVER
CHARLES TAIT, TEMPORARY RECEIVER
FIRST NATIONAL CITY BANK

ALBERT C. LANG, TRUSTEE AND AMERICAN FIDELITY FIRE INSURANCE COMPANY

v.

THE BANK OF NOVA SCOTIA,

THE BANK OF NOVA SCOTIA,
Appellant in 75-2050

FIRST NATIONAL CITY BANK,
Appellant in 75-2051

ON APPEAL FROM JUDGMENT OF THE UNITED STATES DISTRICT COURT SITTING AS A BANKRUPTCY COURT FOR THE DISTRICT OF THE VIRGIN ISLANDS, DIVISION OF ST. CROIX.

Argued December 5, 1975

Before: ALDISERT, WEIS and GARTH, *Circuit Judges.*

OPINION OF THE COURT

(Filed March 24, 1976)

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GARTH, *Circuit Judge*

We are called upon to determine the liability of banking institutions which were not designated as official bankruptcy depositories under the Bankruptcy Act but which nevertheless accepted deposits of bankruptcy funds that were subsequently embezzled. We affirm the district court's order which held both banks liable to the bankrupt's surety even though we do so on a theory different than that adopted by the district court.

I.

These appeals arise from litigation caused by the bankruptcy of Quantum Development Corporation in the Virgin Islands. Quantum had entered into a contract in December, 1971 to construct the Croixville Project, a low-cost multiple housing unit development. Prior to the completion of the project, Quantum became insolvent and defaulted under its contract. Plaintiff-appellee American Fidelity Fire Insurance Company (Fidelity), a surety under a payment and performance bond for Quantum, completed the Croixville Project. As a result of its expenditures and performance under the surety bond, Fidelity asserted claims by way of subrogation to funds of the Quantum estate then under the jurisdiction of the bankruptcy court.[1]

Bank of Nova Scotia (BNS)

Fidelity initially sought to recover $84,858 which the district court had ordered it to deposit in the Quantum estate on March 21, 1973. Pursuant to the court's order, Fidelity delivered to the district court clerk a certified check in the amount of $84,858 payable to the order of "Charles R. Joy, Receiver." Joy was the duly appointed

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1. Fidelity first asserted its claims against Quantum when Quantum was involved in proceedings under Chapter XI of the Bankruptcy Act, 11 U.S.C. § 701 *et seq.* Thereafter, in November, 1973, Quantum was adjudged a bankrupt.

receiver of Quantum under Chapter XI of the Bankruptcy Act.

The bankruptcy referee had instructed Joy to purchase certificates of deposit at the highest rate of interest available with the major portion of the Quantum funds and to place the balance in a checking account. Joy endorsed the Fidelity check which was payable to the order of "Charles R. Joy, Receiver" as follows:

> For Deposit in Quantum Acct.
> Quantum Bankruptcy, Charles R. Joy

On April 2, 1975 Joy presented this check to the Christiansted branch of the Bank of Nova Scotia (BNS) and used $75,000 of the proceeds to purchase three certificates of deposit.[1A] He left the balance of the funds on deposit in a checking account at BNS. BNS was not a designated depository for bankrupty funds under Section 61 of the Bankruptcy Act. Joy requested, and BNS issued, the certificates of deposit to "Charles R. Joy", without any reference to, or designation of, his representative capacity.

On October 2, 1973, when the certificates of deposit matured, BNS issued to "Mr. Charles R. Joy" a check for $77,664.54, representing the principal sum of $75,000 plus interest of $2,664.54. Joy embezzled the proceeds of this check. As a result,, Fidelity commenced this suit against BNS to recover the $77,664.54.[2]

1A. Under Virgin Islands law, a certificate of deposit is "an acknowledgment by a bank of receipt of money with an engagement to repay it." 11A V.I.C. § 3-104(2)(c) (1965). For our purposes there is no distinction between the principles applicable to demand or time deposits and certificates of deposit. "Legally, deposits on time certificates constitute a part of the deposit liability of a bank, just as much as those on demand certificates or in general checking accounts. . . ." Comm'r. of Internal Revenue v. Ames Trust & Sav. Bank, 185 F.2d 47, 49 (8th Cir. 1950).

2. Fidelity's complaint also sought recovery of the proceeds of a certified check for $12,000 which Joy had withdrawn from the Quantum checking account. Apparently, Fidelity abandoned this claim in the district court. In Re Quantum Development Corporation, 397 F. Supp. 329, 333 (D. V.I. 1975). Whether or not this claim was abandoned, the district court did not hold BNS liable for the $12,000 and Fidelity did not cross appeal. This claim is not, therefore, before us.

First National City Bank (Citibank)

Fidelity also sought to recover the Croixville Project retainages totalling $115,211. The district court's order of April 13, 1973 directed Behrens Mortgage Company to pay this retaining sum to Joy. A check was issued in the amount of $115,211 made payable to the order of

> Charles R. Joy, Receiver Quantum
> Development Corporation VI No. 5-1972
> In Bankruptcy Pursuant to Court Order
> of April 13, 1973.

Joy endorsed the check

> Charles Joy, Receiver
> Quantum Corp.

On September 10, 1973 Joy presented this check to the Christiansted branch of First National City Bank (Citibank) and used the entire proceeds to purchase a certificate of deposit. Citibank was not a designated depository for bankruptcy funds under Section 61 of the Bankruptcy Act. The application for the certificate of deposit was prepared in the name of "Charles R. Joy, Receiver," but the certificate was made payable to "Charles R. Joy", without any designation of his representative capacity.

The certificate matured on November 12, 1973. On November 19, 1973, Joy informed Citibank that he did not wish the certificate renewed. Instead he instructed Citibank to cable the principal and interest, totalling $117,571.51, to the City National Bank of Miami, payable to himself. Thereafter, Joy absconded with the $117,571.51.

Fidelity initially commenced suit against Joy as receiver of Quantum. After Joy embezzled the funds, Fidelity filed a supplemental complaint against Citibank to recover the $117,571.51 taken by Joy from the Quantum estate.

II.

After trial the District Court for the Virgin Islands, sitting in bankruptcy,[3] held BNS liable to Fidelity in the amount of $77,664.54 plus interest and held Citibank liable to Fidelity in the amount of $117,571.51 plus interest. In so holding the district court rejected Fidelity's argument that a bank which accepts bankruptcy funds but has not been designated as a depository under the Bankruptcy Act becomes a trustee *ex maleficio* to the extent of such funds and is liable without more for all subsequent misappropriations. Rather, the district court predicated the banks' liability on their failure to comply with the restrictive endorsements on the checks. *In Re Quantum Development Corp.*, 397 F. Supp. 329 (D. V.I. 1975).

At BNS Joy had presented a check payable to his order as receiver and endorsed by Joy.

> For Deposit in Quantum Acct.
> Quantum Bankruptcy Charles R. Joy.

Although this check was restrictively endorsed,[4] BNS issued certificates of deposit in the individual name of "Charles R. Joy", with no reference to Joy's representative capacity as receiver.

At Citibank, Joy had presented a check payable to the order of

> Charles R. Joy, Receiver Quantum
> Development Corporation VI No. 5-1972
> In Bankruptcy Pursuant to Court Order
> of April 13, 1973.

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3. Fidelity's suit against Citibank started before a bankruptcy referee in January, 1974. When it became apparent that the bankruptcy referee would himself be called as a witness in the proceeding, the district court judge assigned both the BNS and Citibank actions to himself under Bankruptcy Rule 102.

4. Under Virgin Islands law,

> An indorsement is restrictive which . . .
>
> (c) includes the words "for collection", "for deposit", "pay any bank", or like terms signifying a purpose of deposit or collection; . . .

11A V.I.C. § 3-205 (1965).

which was restrictively endorsed "Charles Joy Receiver Quantum Corp." However, Citibank issued a certificate of deposit payable to "Charles R. Joy" as payee.

The district court, relying on Virgin Islands law, 11A V.I.C. § 3-419(4),[5] and decisional law,[6] concluded that each bank was liable for failing to apply the proceeds of each check consistently with the restrictive endorsements.

Defendants-appellants BNS and Citibank timely appealed from the district court's order of July 24, 1975[7] adjudging them liable to Fidelity for $77,664.54 plus interest and $117,571.51 plus interest respectively. This Court has jurisdiction pursuant to 28 U.S.C. § 1291.

III.

Since the enactment of the Bankruptcy Act of 1898, Congress has imposed special requirements upon financial institutions selected to receive bankruptcy funds for deposit. While Quantum was in Chapter XI proceedings,[8] Section 47(a)(2) of the Bankruptcy Act, 11 U.S.C. § 75

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5. 11A V.I.C. § 3-419(4) provides:

> (4) An intermediary bank or payor bank which is ***not a depositary bank*** is not liable in conversion solely by reason of the fact that proceeds of an item indorsed restrictively (§§ 3-205 and 3-206) are not paid or applied consistently with the restrictive indorsement of an indorser other than its immediate transfer. (Emphasis added.)

The district court reasoned that this section implicity imposed liability upon a depository bank which did not apply the proceeds of a check in accordance with the restrictive endorsement.

6. The district court relied upon Duckett v. National Mechanic's Bank of Baltimore, 86 Md. 400, 38 A. 983 (1897) and Bank of Giles County v. Fidelity & Deposit Co. of Maryland, 84 F.2d 321 (4th Cir. 1936).

7. The district court's July 24, 1975 order was amended on August 14, 1975 to delete certain collateral matters not relevant to this appeal. No appeal was taken from the amended order.

8. The new Bankruptcy Rules, prescribed by the Supreme Court pursuant to 28 U.S.C. § 2075 (Supp. 1976), are inapplicable to the rights of the parties in this case. These rules did not become effective in Chapter XI proceedings until July 1, 1974, and Quantum was in Chapter XI only until November 30, 1973. We note that the new rules carry forward without change the same basic requirements with respect to the depositing of bankruptcy funds in designated depositories. *See* Bankruptcy Rules 11-52, 605(b), 512.

(a),[9] required that trustees and receivers "deposit all money received by them in designated depositories . . . ." The complement to this requirement was found in Section 61 of the Act, 11 U.S.C. § 101,[10] which required that the bankruptcy court designate *by order* those banking institutions authorized as depositories for the deposit of estate funds. Each depository designated by order was required to provide "a good and sufficient bond with surety, to secure the prompt repayment of the deposit." At the particular times that Joy deposited the Quatnum checks in BNS and Citibank, the bonds required under Section 61 were to substantially provide that

> . . . the banking institution, so designated, shall well and truly account for and pay over all moneys deposited with it as such depository, and shall pay out such moneys only as provided by the Act and applicable general orders and court rules, and shall abide by all orders of the court in respect of such moneys, and shall otherwise faithfully perform all duties pertaining to it of such depository . . . .

General Orders in Bankruptcy No. 53. Federal law thus mandated: (1) that only banks which were designated

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9. Section 47(a)(2) provided:

a. Trustees shall . . .

(2) deposit all money received by them in designated depositories initially in demand deposits; and subsequently, if authorized by the court, in interest-bearing savings deposits, time certificates of deposit or time deposits-open account; . . .

This section was made applicable to Chapter XI proceedings by Section 302 of the Bankruptcy Act, 11 U.S.C. § 802. *See also* R. J. Reynolds Tobacco Co., Inc. v. A. B. Jones Co., Inc., 54 F.2d 329, 335 (8th Cir. 1931); General Orders in Bankruptcy Nos. 53(5), 48(2).

The bankruptcy referee had instructed Joy to deposit the major portion of the Quantum funds in certificates of deposit. *See* p. 4, *supra;* Tr. 136 (April 4, 1975).

10. Section 61, which applied to Chapter XI as well as to bankruptcy proceedings, *see* 3A Collier on Bankruptcy ¶ 61.01[3] at 1346 (14th ed.), provided in pertinent part:

> The judges of the several courts of bankruptcy shall designate, by order banking institutions as depositories for the money of estates under this Act, as convenient as may be to the residences of receivers and trustees, and shall require from each such banking institution a good and sufficient bond with surety, to secure the prompt repayment of the deposit . . . .

by court order and which furnished the requisite bond could receive bankruptcy funds for deposit; and (2) that receivers were prohibited from depositing estate funds in other than such designated institutions.

It is undisputed that neither BNS nor Citibank were designated as depositories for bankruptcy funds. Fidelity argues here, on the authority of *American Surety Co.* v. *First National Bank,* 141 F.2d 411 (4th Cir.), *cert. denied,* 322 U.S. 754 (1944), that the acceptance of the Quantum bankruptcy funds by BNS and Citibank without a court order designating them as official depositories under the Bankruptcy Act resulted in both banks becoming trustees *ex maleficio* of the funds which were subsequently misappropriated by Joy. Not surprisingly, BNS and Citibank dispute the applicability of *American Surety,* asserting that the mere failure to be designated as an official depository should not result in liability.

IV.

The issue thus framed by these opposing contentions is whether the mere acceptance of bankruptcy fund deposits by a bank which has not been court designated as an official depository imposes liability upon the bank for all subsequent misappropriations of the funds. Although the Bankruptcy Act does not by its terms impose liability upon the offending bank in such a situation, we conclude that liability is mandated to effectuate the Act's overall policy which is to safeguard estate funds for creditors. *In re Potell,* 53 F.2d 877, 879 (E.D. N.Y. 1931). In reaching this conclusion we emphasize that we are not concerned here with the liability, if any, arising from improper disbursements made by fiduciaries from estate accounts maintained in and by officially designated depositories. This latter situation, which is to be distinguished from ours, involves different policy considerations. *See* Uniform Fiduciaries Act, 15 V.I.C. § 1049 (1964). The liability of such banks which are officially designated de-

positories may depend upon participation in, or knowledge of, the fiduciary's illegal activities. Here, however, where the banks accepted bankruptcy funds without court designation, we impose absolute liability solely because of the acceptance of such funds in violation of the Bankruptcy Act.

We recognize that the situation which our case presents has occurred infrequently over the years. As a result there is little in the way of precedent to furnish us guidance. Nevertheless, even the few authorities that have spoken to this and related subjects have for the most part concluded, as have we, that liability should be visited upon the nondesignated bank at the time of, and solely as a result of, the acceptance of funds that could only be legally deposited in an officially designated institution. These cases emphasize that liability attaches at the time of acceptance of the deposit because it is at that time that the bank, on notice that the funds could only be legally deposited in a designated institution, nevertheless accepts the deposit proferred by a fiduciary acting in violation of law.

This concept of liability first appeared in contexts different than the one which concerns us, but which are nevertheless analogous in principle. Two general categories of cases discuss the liability of nondesignated depositories: (1) those in which deposits of public funds are made by public officers;[11] and (2) those in which deposits of bankruptcy funds are involved.[12]

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11. American Surety Co. v. Jackson, 24 F.2d 768 (9th Cir. 1928); Allen v. United States, 285 F. 678 (1st Cir. 1923); Board of Comm'rs v. Strawn, 157 F. 49 (6th Cir. 1907); Merchants' Nat'l Bank v. School Dist. No. 8, 94 F. 705 (9th Cir. 1899); *see also* Cook v. Elliott, 73 F.2d 916 (4th Cir. 1934); Coos County v. Berlin Nat'l Bank, 21 F. Supp. 523 (D. N.H. 1937); 5 A. Scott, Law of Trusts § 528 (3d ed. 1967).

12. American Surety Co. v. First Nat'l Bank, 141 F.2d 411 (4th Cir.), *cert. denied*, 322 U.S. 754 (1944); In re Potell, *supra; see also* Hillsdale Grocery Co. v. Union & People's Nat'l Bank, 6 F. Supp. 773 (E.D. Mich. 1934). *Contra*, Irving Trust Co. v. United States, 83 F.2d 20 (6th Cir. 1936); In re Bogena & Williams, 76 F.2d 950 (7th Cir. 1935); Rodgers v. Bankers' Nat'l Bank, 179 Minn. 197, 229 N.W. 90 (1930).

In the "public fund-public officer" cases, either a statute or ordinance explicitly prohibited a public officer or fiduciary from depositing trust funds in other than an officially designated or authorized depository. In each instance, the deposit was made in a nondesignated bank which subsequently failed. In each case, the bank was held chargeable with notice of the statute that required the deposit of funds in a designated institution. Despite the competing equities of the general depositors and creditors of the insolvent bank, in each instance, the bank was held liable to the public as a trustee for all the public funds deposited.

This same theory of liability has been applied to banks which accepted the deposit of bankruptcy funds without having been designated as official depositories under Section 61 of the Bankruptcy Act. In *In re Potell, supra,* the receiver of an adjudicated bankrupt (Potell) opened an account for the estate in a nondesignated bank. Thereafter the bank became insolvent. The receiver sought to hold the bank liable for the entire account of the bankrupt estate in preference to the claims of the bank's creditors and depositors.

The district court focused upon the receiver's deposit, and the bank's acceptance, of bankruptcy funds in violation of the Bankruptcy Act. The court stated:

> It is plain therefore that the said receiver in bankruptcy had no right to deposit money of the bankrupt estate contrary to the above provisions of the laws and rules. That whether or not a bank was a designated depository was easily ascertained and a public record. That the officers of the bank knew or should have known that it was not a designated depository. They knew or should have known that they had not even presented nor had filed the bond without which no designation would be made.

53 F.2d at 879. Therefore, in receiving the money "with full knowledge of the peculiar character of the deposit and

in opening a prohibited account," the bank accepted the funds "impressed with . . . [a] trust." *Id.* at 880.[13] In subordinating the equities of the bank's creditors to the claim of the bankrupt *Potell* estate, the district court ordered the same remedy applied as had been utilized in the public fund-public officer cases—a return of the bankruptcy funds in full to the receiver.[14]

The most recent expression of this rule of liability is to be found in the case most nearily analogous to our own, *American Surety Co. v. First National Bank,* 141 F.2d 411 (4th Cir.), *cert. denied,* 322 U.S. 754 (1944).[15] Unlike the cases previously discussed, *American Surety* involved a suit against a bank to recover funds of a bankrupt estate misappropriated by the trustee. The bank which was not a designated depository under the Bankruptcy Act accepted deposits of checks drawn to the order of the trustee in bankruptcy and endorsed by him as trustee in bankruptcy. Thereafter, the trustee withdrew the funds of the estate for his personal purposes.

The court held that the bank's receipt of bankruptcy funds without having been designated as an official depository rendered it liable for the funds subsequently mis-

13. In Allen v. United States, *supra,* relied upon in In re Potell, the court held that the United States was entitled to recover against the bank's receiver all monies which had been deposited by a postmaster in a bank which thereafter became insolvent. Under statutes then in effect, the postmaster was forbidden to deposit public moneys in a depository that had not been authorized by the United States to receive such funds. Citing a number of "public fund-public officer" cases (*see* note 11 *supra*) the court held that the bank had acquired these funds as trustee *ex maleficio* and that all such funds were held by the bank impressed with a trust in favor of the United States.

14. We recognize that in two cases, Irving Trust Co. v. United States, *supra* note 12, and In re Bogena & Williams, *supra* note 12, involving similar circumstances, the courts reached conclusions contrary to In re Potell. Neither these cases nor In re Potell involve our exact situation. *Irving Trust, Bogena,* and *Potell* all concern claims by bankrupt estates against insolvent, nondesignated depositories. Our case does not. However, to the extent that these cases are analogous to ours, we regard the analysis and reasoning of *Potell* as more persuasive. *See also* American Surety Co. v. First Nat'l Bank, *supra* note 12, at 415.

15. Although *American Surety* involved the misappropriation of bankruptcy funds in a straight bankruptcy proceeding and we are concerned here with the misappropriation of Chapter XI funds, the same statutory provisions and policy considerations are involved thereby requiring the same rule of liability.

appropriated by the trustee. In reaching this determination the court found the applicable rule to be that stated in the Restatement of Trusts § 324, comment b (1935):[16]

> If a trustee commits a breach of trust in depositing trust funds in a bank and the bank when it receives the funds has notice of the breach of trust, the bank is liable for participation in the breach of trust, and is chargeable as a constructive trustee of the funds.
>
> Thus, if a bank receives on deposit funds which it knows are trust funds and which it knows that the trustee is forbidden by the terms of the trust to deposit in the bank, it is liable for participation in the breach of trust, and is chargeable as a constructive trustee of the funds deposited.

141 F.2d at 413.

There was little doubt that the trustee's deposit of bankruptcy funds in a nondesignated bank in violation of Sections 47 and 61 of the Bankruptcy Act (*see* notes 9, 10, *supra*) constituted a breach of trust. The court emphasized:

> It is perfectly clear that the purpose of these provisions [Sections 47 and 61] was to protect the funds of bankrupt estates, not merely to designate banks in which trustees might deposit funds without incurring personal liability, and that their effect was to forbid the deposit of bankruptcy funds in a bank which is not a designated depository . . . .

Id.

Furthermore, the court found that

> [t]he bank took the deposit of bankruptcy funds not merely with notice, but with notice so full as to leave

16. This rule has been incorporated unchanged in the Restatement (Second) of Trusts § 324, comment b (1957).

no doubt that there was actual knowledge on the part of the bank's officers of the breach of trust of which the trustee was guilty in making the deposit. The checks were payable to the trustee as "trustee in bankruptcy of Eli Nutter" and were so endorsed. The fact that they covered funds belonging to the bankrupt estate was thus not a mere matter of notation on the checks which the bank was without obligation to notice, but was incorporated as a limitation upon the right of the trustee to receive payment, of which the bank was bound to take notice in accepting the checks. The rule is established by the great weight of authority that "where there are words indicating a representative or fiduciary character following the name of a payee, indorser, or indorsee on commercial paper deposited in a bank, the bank is chargeable with notice of the trust character of the instrument." (Citations omitted.)

Id. at 413-14. Certainly the payment orders and the endorsements on the checks put the bank on notice that it was accepting bankruptcy funds. But it is unclear on what basis the court resolved that the bank had notice of the trustee's breach of trust. The opinion does indicate that the bank cashier had actual knowledge "of the restrictions applicable to the deposit of bankruptcy funds." *Id.* at 414. However, the court relied on the public fund-public officer cases in which knowledge of the statute that made the public officer's deposit unlawful was imputed to the bank. In fact, the court concluded:

> No different principle [than that applied in the public fund-public officer cases] is applicable, we think, with respect to the deposit of bankruptcy funds. It is true, as argued, that such funds are private and not public funds; but this is a distinction without a difference. The controlling consideration is that, just as in the case of public funds, the law requires deposit

> in a designated depository, that deposit elsewhere is without legal authority and that a bank receiving the deposit with notice of its trust character must hold it subject to the trust or respond in damages for failure to do so.

Id.

Since the requirements of Section 324, comment b of the Restatement of Trusts were satisfied, the court in *American Surety* held

> . . . that the deposit itself constituted a breach of trust on the part of the trustee of which the bank had ample notice, and that, upon the receipt of the deposit under such circumstances, the bank became a trustee *ex maleficio* of the amount so received and liable therefor as a trustee to the estate of the bankrupt.

Id. at 413. Thus, the bank was liable to the extent of the bankruptcy funds deposited and thereafter misappropriated by the trustee.

Only the Minnesota Supreme Court in *Rodgers* v. *Bankers' National Bank,* 179 Minn. 197, 229 N.W. 90 (1930), has reached a result in a similar context different than that reached in *American Surety.* In *Rodgers* the Minnesota court held that the Bankruptcy Act was not intended to impose liability upon a nondesignated bank that accepts bankruptcy funds which are subsequently misappropriated. We agree with the Fourth Circuit's conclusion in *American Surety* that the *Rodgers* analysis should be rejected. Adherence to *Rogers* would thwart rather than effectuate the policy of the Bankruptcy Act. Only the rule of liability applied in *American Surety* serves to protect bankrupt estates from loss. We therefore reject the *Rodgers* decision and the reasoning upon which it is predicated.

As in *American Surety,* we apply the rule of liability set forth by the Restatements (First and Second) of Trusts

§ 324, comment b (1935, 1957) to the situation before us. *See* p. 13 and note 16, *supra*. Under this rule, as applied to the circumstances here, a bank is chargeable as a constructive trustee of bankruptcy fund deposits made by a receiver (1) if the receiver committed a breach of trust in making the deposit; and (2) if the bank accepted the deposits with notice of the breach of trust.

It is conceded that neither BNS nor Citibank were designated depositories for bankruptcy funds under Section 61 of the Bankruptcy Act. Thus, Joy, as receiver of Quantum, violated Section 47 of the Bankruptcy Act (*see* note 9, *supra*) by depositing bankruptcy funds in nondesignated banks.

Furthermore, both BNS and Citibank accepted these funds with notice of Joy's breach of trust. The deposit of checks payable to the order of Joy as receiver of Quantum, and endorsed by Joy in his representative capacity, constituted notice to the banks that they were accepting bankruptcy funds. *American Surety, supra* at 413-14. From this notice as to the nature of the funds, it follows that the banks accepted these monies for deposit with notice of Joy's breach of trust. Unlike the situation in *American Surety,* where the bank cashier apparently had knowledge (albeit erroneous knowledge) of the requirements of the Bankruptcy Act, it is clear from the testimony of the BNS and Citibank employees that they had no such knowledge. Nevertheless, we conclude that both banks are chargeable with knowledge of Sections 47 and 61 of the Banruptcy Act and with notice of Joy's breach of trust.

In charging the banks with knowledge of the Act's provisions respecting the deposit of bankruptcy funds, we do no more than impose the same standard adopted by the courts in the public fund-public officer cases. *See* note 11, *supra*. Those courts imputed knowledged to the banks of the statutes or ordinances that prohibited the deposit of public funds in other than an official depository. Moreover, our conclusion merely represents an application in the bankruptcy context of the fundamental principle that "everyone is charged with knowledge of the United States Statutes at Large . . . ." *Federal Crop Ins. Corp.* v. *Merrill,* 332 U.S. 380, 384 (1947); *Cole* v. *Railroad Retirement Board,* 289 F.2d 65, 68 (8th Cir. 1961). Large commercial banks such as BNS and Citibank, which stand to profit from the deposit of bankruptcy funds, cannot claim ignorance of at least those provisions of the Bankruptcy Act which are relevant to their operations. To allow major financial institutions to accept deposits of bankruptcy funds oblivious to the designation and bond requirements of the Act would dangerously undermine the safeguards created by Congress for the creditors of bankrupt estates. This we refuse to do.

Thus, both BNS and Citibank are chargeable with notice that Joy presented bankruptcy funds for deposit and with knowledge that the acceptance of such funds for deposit in nondesignated banks violated the Bankruptcy Act. BNS and Citibank therefore took the bankruptcy fund deposits as constructive trustees or trustees *ex maleficio* and are absolutely liable for the subsequent misappropriations of these funds by the receiver, Joy.

In concluding as a matter of federal law[17] that BNS and Citibank are liable to Fidelity for accepting bankruptcy fund deposits in violation of the Bankruptcy Act, we need not reach the local law grounds for the district court's finding of liability. Although we predicate our decision on a ground different than that relied upon by the district court, we may nevertheless affirm a correct decision of the district court. *PAAC* v. *Rizzo,* 502 F.2d 306, 308 n.1 (3d Cir. 1974), *cert. denied,* 419 U.S. 1103 (1975).

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17. The liability of banks accepting bankruptcy fund deposits in violation of the provisions of the federal Bankruptcy Act is a matter of federal law. *See American Surety, supra* at 416-17 relying upon Clearfield Trust Co. v. United States, 318 U.S. 363 (1943) and Sola Electric Co. v. Jefferson Electric Co., 317 U.S. 173 (1942).

The order of the district court directing that Fidelity recover the respective amounts claimed against BNS and Citibank plus interest will be affirmed.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

Appendix B.

IN THE DISTRICT COURT OF THE VIRGIN ISLANDS
DIVISION OF ST. CROIX

QUANTUM DEVELOPMENT CORPORATION, Bankrupt.	Bankruptcy 5/1972
AMERICAN FIDELITY FIRE INSURANCE COMPANY, Plaintiff, CHARLES JOY, Receiver, ALBERT C. LANG, Temporary Receiver, FIRST NATIONAL CITY BANK, Defendants.	Adversary Proceeding No. 1
ALBERT C. LANG, Trustee, and AMERICAN FIDELITY FIRE INSURANCE COMPANY, Plaintiffs, *against* THE BANK OF NOVA SCOTIA, Defendant.	Adversary Proceeding No. 2

WILLIAM T. HOLMES, Esq.
LEO HIRSCH, Esq.
For American Fidelity Fire Insurance Co.

JAMES H. ISHERWOOD, Esq.
For Bank of Nova Scotia

ROGER CAMPBELL, Esq.
For First National City Bank

JOHN K. DEMA, Esq.
Trustee in Bankruptcy

MEMORANDUM OPINION AND JUDGMENT
(Filed July 24, 1975)

YOUNG, District Judge

I

Background Facts

Plaintiff American Fidelity Fire Insurance Company ("AFFIC"), Surety of the bankrupt Quantum Development Corporation ("Quantum"), brings this action to recover from the defendants Bank of Nova Scotia ("BNS") and First National City Bank ("Citibank") certain moneys, former bankruptcy funds to which AFFIC has become entitled by subrogation, which were embezzled by Quantum's original bankruptcy receiver, Mr. Charles Joy.

A.

Facts as to BNS

In compliance with an Order of this Court dated March 21, 1973, pursuant to which AFFIC was to deliver a certified check in the amount of $84,858.00 to the Clerk of the District Court of the Virgin Islands on or before March 30, 1973, Surety caused that amount to be transferred by wire to Chase Manhattan Bank in San Juan, Puerto Rico, for the account of Benitez and Associates, Inc. ("Benitez"), an authorized agent of AFFIC. Because Benitez was unable to obtain a certified check on its account in sufficient time to meet this Court's deadline, it obtained a certified check of Builders Insurance Company, a corporation affiliated with Benitez. Such action on the part of Benitez was subsequently ratified by AFFIC, its principal. Benitez instructed Builders to issue the check to the order of "Charles R. Joy, Receiver". The check was thereupon delivered by an AFFIC attorney to the Clerk of this Court. A receipt was issued for the check, and it was then turned over to Charles Joy.

Prior to this time, Bankruptcy Judge Rivera-Cruz instructed Joy to put the bulk of the $84,858.00 into certificates of deposit at the highest rate available and to open a small checking account with the balance. Joy then telephoned a number of banks in the Virgin Islands to obtain the current interest rates on certificates of deposit. On March 30, 1973, he was quoted a rate by the Bank of Nova Scotia. Several days later, on April 2, 1973, he took the check to Bank of Nova Scotia where he met William Chandler, then manager of the Christiansted branch of the bank. At trial, Mr. Chandler testified that prior to April 2, 1973, he had read about Quantum bankruptcy in the newspapers and had known Charles Joy only casually. During the April 2nd conversation, Joy requested certificates of deposit in the amount of $75,000.00 and further stated that he wished to open a checking account. Mr. Chandler noted that the check was payable to "Charles R. Joy, Receiver", but denied having seen the endorsement on the reverse side of the check, which read:

> "For Deposit in Quantum Acct. Quantum Bankruptcy Charles R. Joy."

Without referring to the form of the endorsement, Mr. Chandler then instructed his secretary to prepare the CD's in the manner requested by Mr. Joy. The CD's were ultimately issued in the name of "Charles R. Joy" without words which might denote his representative capacity.

Several weeks later, Joy called Chandler to inform him that a counter-signature would thereafter be required on the checking account, and that Judge Rivera-Cruz would be coming into the bank to provide a specimen of his signature. Sometime between May 1st and the 18th, Judge Cruz went to the bank, accompanied by Mr. Joy, for that stated purpose. During the visit, Judge Cruz informed Chandler that this was a Quantum bankruptcy account; that although Mr. Joy, as Receiver, was the true customer, he wanted some control over the account. Critical at this juncture is whether the counter-signature was placed only on the checking account or upon all Quantum transactions. Judge Cruz

testified that at the time, he was not aware that Joy had already put the money into certificates of deposit, and that he did not mention anything to Mr. Chandler regarding the CD's specifically. In his recollections of his encounter with Judge Cruz, Chandler stated that the Quantum bankruptcy was never mentioned, but that the judge's presence indicated to him that bankruptcy funds were involved. Chandler denied that Judge Cruz placed any counter-signature requirement on the CD's but admitted in an earlier deposition that he assumed the same restriction would apply to the CD's as well as the checks. He spoke to no one in the bank's CD department of this assumption, and took no steps to ensure that the CD's would be similarly restricted.

The legend, "All cheques to be counter-signed by Judge Cruz", was typed on the current ledger of the checking account, was carried forward to a few subsequent ledger sheets and was then omitted. Mr. Chandler left the Christiansted Branch of BNS on May 18, 1973 to become Manager of a branch of the same bank in Halifax, Nova Scotia.

On October 2, 1973, upon maturity of the three certificates of deposit, BNS issued to "Mr. Charles R. Joy" individually a check for $77,664.54, representing the principal sum plus $2,664.54 of interest thereon. With these funds, Joy, on October 2, bought a certificate of deposit, due December 1, 1973, in his individual name from Citibank. This CD was cashed by Joy on December 3, 1973.

On October 16, 1973, BNS certified a $12,000.00 check drawn by Joy to his own order and countersigned, as per restrictive endorsement, by Judge Cruz. The check was later endorsed by Joy and cashed at Citibank in Christiansted.*

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* Because BNS properly attached a counter-signature requirement to the checking account and the $12,000.00 check was indorsed in accordance therewith, AFFIC makes no claim for this amount.

B

FACTS AS TO CITIBANK

The trial of this case commenced January 18, 1974 before Bankruptcy Judge Rivera-Cruz. During the course of the trial, it became evident that Judge Cruz would become a witness in the case, and the matter was concluded before me on April 2, 1975.

Pursuant to an Order of this Court dated April 13, 1973, wherein Behrens Mortgage Company was directed to pay to Charles Joy $115,211.00 in retainages on the Croixville construction project upon the final closing thereof, Behrens on September 7, 1973, issued a check in that amount to the order of:

> "Charles R. Joy, Receiver Quantum Development Corporation VI No. 5-1972 In Bankruptcy Pursuant to Court Order of April 13, 1973."

Several days later, on September 10, Joy discussed the purchase of a certificate of deposit with Lawrence J. Cavanaugh, manager of the Christiansted Branch of Citibank. Mr. Joy noted that he had his personal account in the Sunny Isles branch of Citibank, and after Mr. Cavanaugh quoted an interest rate of 10¾%, an application was prepared for the CD. The check was endorsed "Charles Joy Receiver Quantum Corp.", and the application was made out in favor of "Charles R. Joy, Receiver". The application was then delivered to Mrs. Bailey, Cavanaugh's secretary, with instructions to prepare the CD. All terms of the CD, as made out by Mrs. Bailey, conformed to the application, except that the CD was made out in favor of "Charles R. Joy," with the word "Receiver" omitted. Mrs. Bailey's only explanation for the foregoing omission was: "As far as I know it was just a typographical error." Mr. Cavanaugh then signed the CD.

This certificate of deposit dated September 10 and in the amount of $115,211.00 was automatically renewed upon

maturity on November 12 for an additional sixty days, and a $2,131.71 check, representing interest for the initial sixty-day period, was issued to Joy. On or about October 12, 1973, Mr. Cavanaugh went on leave from the bank and Mr. Chardon became Acting Manager of the Christiansted Branch. On November 19, Joy informed Mr. Chardon that he did not wish the CD renewed, that he wanted both the interest check and the CD cashed (representing a total of $117,571.51), and the proceeds therefrom cabled to City National Bank of Miami and made payable to himself.

Sometime thereafter, Charles Joy absconded with both the $117,571.51 and the $89,664.54 discussed in Part IA, *supra* and no part of these sums has ever been returned to Joy's successors. On September 11, 1974, a judgment was entered by this Court in favor of Mr. Tait, as Trustee, against Joy in a conversion action in the sum of $196,623.26 plus interest. This judgment remains wholly unsatisfied.

It is uncontroverted in the record before this Court that neither Mr. Chandler at BNS nor Messrs. Cavanaugh and Chardon at Citibank had ever opened bankrutcy accounts for trustees or receivors in bankruptcy; that none knew whether his bank was a designated depository for bankruptcy funds; and that none had knowledge of the statutes requiring banks to be so designated prior to the acceptance of such funds.

II

Liability of BNS

Plaintiff Surety predicated its claim of recovery against BNS on three distinct legal theories: (1) that a bank not a designated depository for bankruptcy funds who nonetheless receives such deposits may become a trustee ex maleficio for the funds; (2) that a counter-signature requirement was placed on the CD's, and the failure of BNS to abide by the restrictive endorsement renders it liable; and (3) that BNS issued the CD's contrary to instructions.

(1)

Plaintiffs' initial claim requires an analysis of the Fourth Circuit decision in American Surety Co. v. First National Bank, 141 F.2d 411 (4th Cir.), *cert. denied,* 322 U.S. 754 (1944). In that case, a lawyer became trustee of a bankrupt estate and deposited funds belonging to the estate in a bank which was not a designated depository under the Bankruptcy Act. The lawyer, who maintained a personal account with the defendant bank, gradually embezzled the bankruptcy moneys until the fund was entirely exhausted. In concluding that the bank became a trustee ex maleficio of the amount so received and thus liable therefore as a trustee to the bankrupt estate, the Court grounded its decision on those provisions of the Bankruptcy Act which forbid the deposit of bankruptcy funds in a bank which is not a designated depository. *See* Bankruptcy Act, § 47(a), 11 U.S.C. § 75(a); § 61, 11 U.S.C. § 101; General Orders §§ 29, 53(5). There is no doubt that by virtue of such unauthorized deposit alone, the trustee in bankruptcy becomes guilty of a breach of his trust. *Id.* at 413. The important issue for purposes of the instant case, however, is under what circumstances the bank joins in the trustee's breach.

In its memorandum to the Court, plaintiff suggests that the liability of BNS, which all parties agree was not a designated depository in April of 1973, should be based upon its acceptance of the funds *alone,* on the ground that the bank is imputed with the knowledge of the terms of the Bankruptcy Act and the general orders promulgated thereunder. To begin with, this notion was specifically discredited in the case of Rodgers v. Bankers' National Bank, 229 N.W. 90 (Minn. 1930); and secondly, in light of the Fourth Circuit's finding in *American Surety* that the bank's officers had *actual knowledge* of the breach of trust of which the trustee was guilty in making the deposit, such notion would be dictum.

The leading treatise in the field of bankruptcy, apparently in accord with the view expressed in *Rodgers,*

supra, states that:

> "where a bank is *not* a designated depository, § 61 and General Order 29, as well as § 47A(2) are not intended to define the liability of a bank generally having business relations with trustees or receivers in bankruptcy. These provisions are said to be directed to designated depositories and the bankruptcy receivers and trustees; hence, the law applicable generally to a bank receiving deposits of fiduciary funds controls, even though the funds belong to a judicial or official trust and their deposit is in violation of a law defining the duties of the proper custodians. Consequently, such a bank is not liable for the dissipation of funds deposited by a trustee contrary to the Act and General Orders, merely because of its acceptance of such a fiduciary deposit."

3A Collier on Bankruptcy, ¶ 61.04 (14th ed. 1974); *see also* Rodgers, *supra,* at 95-96.

On its face, *American Surety* appears to hold that the mere receipt of bankruptcy funds by a bank not a designated depository renders it liable. A closer scrutiny of the decision, however, reveals that no such reading of the decision was intended. The law on which the Court based its decision was the Restatement of the Law of Torts, section 324, comment b, which reads:

> "If a trustee commits a breach of trust in depositing trust funds in a bank *and the bank when it receives the funds has notice of the breach of trust,* the bank is liable for participation in the breach of trust, and is chargeable as a constructive trustee of the funds."
>
> "Thus, if a bank receives on deposit that *which it knows are trust funds and it knows that the trustee is forbidden by the terms of the trust to deposit in the bank,* it is liable for participation in the breach of trust, and is chargeable as to a constructive trustee of the funds deposited."

American Surety, *supra* at 413 (emphasis added).[1] After isolating the legal standard under which it was to proceed, the Fourth Circuit then made factual findings that not only did the bank know the nature of the funds deposited with it (i.e., bankruptcy funds), but also that such deposit was illegal. *Id.* at 413-14. For, "[t]he cashier was an experienced banker and knew of the restrictions applicable to the deposit of bankruptcy funds". *Id.* at 414.

Although Mr. Chandler testified at trial that he did not know the funds were bankruptcy funds until sometime after the funds had been deposited, such notice can unquestionably be imputed to him by the endorsement on the back of the $84,858.00 check presented to him by Charles Joy on April 2, 1973. I cannot find, however, that Chandler or anyone else at BNS had knowledge of the illegality of the deposit. It is entirely conceivable that no one at BNS would have been familiar with the relevant provisions of the Bankruptcy Act or the limitations on deposits of bankruptcy funds. Indeed, there was in fact no designated depository for bankruptcy funds in the Virgin Islands in April of 1973. Furthermore, on the authority of Rodgers v. Bankers' National Bank, *supra,* I cannot impute such knowledge to BNS. *Id.* at 95-96. *Cf.* In re Bogena & Williams, 76 F.2d 950, 953 (7th Cir. 1935).

(2)

Plaintiff's second theory of liability is predicated on the factual assumption that a counter-signature requirement was placed on the CD's as well as the checking account. This contention is not supported by the facts. In light of the fact that Judge Cruz was not even aware that Joy had already purchased CD's at BNS, it is inconceivable that

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[1] The law as stated in Section 324 of the Restatement of Trusts (First) remains substantially unchanged by Section 324 of the Restatement of Trusts (Second) the controlling law in the Virgin Islands today.

such requirement would have been placed thereon by him. The testimony of Chandler supports this view. Even had Judge Cruz made an off-hand reference to "funds" or "trust funds", I find that such direction is not clear or specific enough to restrict the endorsements on the three CD's. In order to impose liability on a bank for its failure to abide by a restrictive endorsement, the limitation must be imposed by clear direction rather than ambiguity or surmise. *See, e.g.,* Citizens National Bank v. Hill, 505 S.W. 2d 246, 248 (Tex. S. Ct. 1974).

(3)

Plaintiff's final claim focuses on the alleged failure of BNS to issue the CD's in accordance with the instructions given it by Charles Joy. As heretofore noted, the check which Joy presented to Mr. Chandler was payable to "Charles R. Joy, Receiver", and bore on the back the indorsement "For Deposit In Quantum Acct. Quantum Bankruptcy Charles R. Joy". A perusal of Section 3-205 of the Uniform Commercial Code,[2] intended to provide a functional definition of the term "restrictive indorsement", leaves little doubt that the foregoing fits within the prescription:

> "An indorsement is restrictive which either . . . (c) includes the words 'for collection', *'for deposit'*, 'pay any bank', or like terms signifying a purpose of deposit or collection; or (d) otherwise states that it is for the benefit or use of the indorser or of another person."

IIA V.I.C. § 3-205 (emphasis added). Under either subdivision (c) or (d), the $84,858.00 presented to BNS bore

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[2] The Uniform Commercial Code has been applied in bankruptcy proceedings [*see* In re United Thrift Stores, 363 F.2d 11, 14 (3d Cir. 1966)], and is generally considered to be the federal law of commerce. *See* In re King-Porter Co., 446 F.2d 722, 732 (5th Cir. 1971).

a restrictive indorsement. In addition to stating "For Deposit", the indorsement clearly indicates that it was for the benefit or use of the Quantum bankruptcy estate.

The recognized purpose of a restrictive indorsement is to restrict the use to which the indorsee may put the proceeds of the instrument when a party pays them to the indorsee. No section of the Uniform Commercial Code specifically requires an indorsee-bank to examine the restriction and to ensure that its payment is not inconsistent therewith; nor does any provision set forth any liability on the part of a bank for payment inconsistent with a restrictive indorsement. But, despite the absence of any explicit reference thereto, such duty and resulting liability for the failure to carry out such duty can be fairly inferred from a number of Code sections.

Section 3-206(2), for example, permits an intermediary bank, or a payor bank *which is not the depository bank,* to disregard any restrictive indorsement except that of the bank's immediate transferor. Subdivision (3) of the same section requires any transferee other than an intermediary bank to act consistently with the purpose of collection. It is clear that under the facts of the instant case, BNS stands in the position of a depository rather than an intermediary bank. *See* 11A V.I.C. § 4-105(a). Thus, at least by negative implication, Section 3-419(4) of the Code provides a remedy in conversion against a depository bank who fails to pay or apply proceeds in accordance with the terms of a restrictive indorsement. *See* Salsman v. National Community Bank, 246 A.2d 162, 169 (N.J. Super. 1968), *aff'd.* 251 A.2d 460 (N.J. App. 1969). Subdivision 3 of section 3-419 further implies the liability of a depository bank in conversion when it deals with an instrument or its proceeds on behalf of one who is not the true owner, where the bank does not act in accordance with "reasonable commercial standards". *Id.* at 168. By his own admission, Mr. Chandler never examined the indorsement on the check, which indorsement was made in his

presence. Instead, he merely instructed his secretary to make out the CD's in accordance with Mr. Joy's wishes. Certainly, such actions on the part of BNS's branch manager do not comport with reasonable commercial standards. The very least Chandler could have done was to ensure that the inscription on the CD's corresponded to that on the original check. Although he noticed that the check was made out to Joy in his representative capacity, Chandler made no effort to ascertain for whom Joy was a receiver.

Moreover, Section 3-603 of the Code, adopting the general principle that a payor is not required to obey a stop payment order received from an indorser, makes an explicit exception in the case of a depository bank which satisfies the holder of an instrument which has been indorsed in a manner inconsistent with the terms of such restrictive indorsement. *See* 11A V.I.C. § 3-603(1)(b).

Finally, the drafters of the Code provided for circumstances which may not have been specifically covered in their statutory scheme. Section 1-103 states in pertinent part: "Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant . . . shall supplement its provisions." It thus follows that an enumeration by the Code of Acts which constitute a conversion is not exclusive, and the general principles of law relating to the conversion of property remain in force. *See Salsman, supra,* at 168; 1 *Anderson's Uniform Commercial Code* § 3-419.3, at 688 (1961).

The common law rule, sifted from both case precedent and the respected treatises in the field, suggests that if a bank receives a deposit with instructions to place it to the credit of a fiduciary in his representative capacity, and instead credits it to the individual account of the fiduciary, the bank is liable in conversion if the deposit is later disbursed by the trustee for non-trust purposes. *See e.g.,*

Bank of Giles County v. Fidelity & Deposit Co., 84 F.2d 321, 326-27 (4th Cir. 1936); Duckett v. National Mech. Bank, 28 A. 983, 986 (Md. 1897); Restatement of Trusts (Second) § 324, comment e; Bogert, Trusts & Trustees § 906 (2d ed. 1962).

Ignoring the restrictive indorsement inscribed on the back of a check in the substantial amount of over $84,000.00, the bank proceeded to issue to Mr. Joy in his personal and individual capacity the CD's in the amount of $25,000.00 each. Although the bank officials in no way participated in the extreme breach of trust of which Mr. Joy was guilty, their placing the CD's in Joy's individual name provided the opportunity and encouragement which Joy may have needed to perpetrate his scheme.

Plaintiff BNS urges the Court that liability cannot be predicated on the restrictive indorsement theory, because the bank was a holder in due course. BNS ignores, however, the fact that if a Court finds, as I have, that a bank has failed to abide by a restrictive indorsement, that bank is precluded from attaining holder in due course status. Section 3-206 of the Code recognizes that a trust indorsement does not ipso facto give a payor-bank such notice as to deny it the status of a holder in due course. Such payor is, however, immunized from liability by 3-206(2) only insofar as its payment to the trustee or to a purchaser from the trustee is "consistent with the terms" of the trust indorsement. *See* 11A V.I.C. § 3-206, comment 6. Such is not the case here, and BNS is not a holder in due course.

III

Liability of Citibank

(1)

Plaintiff's claim against Citibank sounding in the trustee ex maleficio theory must fail for essentially the same

reasons that that claim as to BNS failed. The record is devoid of any showing that anyone at Citibank had knowledge of the illegality of the $115,211.00 deposit. *See* Restatement of Trusts (Second) § 324. Again, there is no evidence from which the Court might find knowledge on the part of the bank employees of the provisions of the Bankruptcy Act relating to designated depositories and the rightful deposit of bankruptcy funds.

(2)

I now turn to the question of whether Citibank is liable for issuing the CD contrary to instructions. The face of the check presented to Citibank clearly indicated that not only was Joy paid in his representative capacity, but further specified the identity of his principal, Quantum Development Corporation. The indorsement on the back of the check read, "Charles Joy Receiver Quantum Corp.". On the application for the CD was inserted on the line designated "Favor of" the words "Charles R. Joy, Receiver". But despite these three seemingly unequivocal indications that Joy was requesting the CD as a fiduciary of Quantum, the CD was ultimately issued to him in his individual name. Mr. Cavanaugh failed to detect this discrepancy at the time he signed the certificate. Although nothing in the record would indicate that the omission of the word "Receiver" was done intentionally, such omission and the failure of Mr. Cavanaugh to perceive it clearly constitutes negligence on the part of the bank's employees. Such lack of due care becomes even more aggravated when viewed in the context of the large amount of the deposit. As in the BNS factual situation, a CD was issued contrary to instructions, thereby enabling the trustee to commit a defalcation of the proceeds of the CD with greater facility.

Plaintiff Citibank in its post-trial memorandum to this Court relies heavily on the Uniform Fiduciaries Act, as

enacted by the Virgin Islands in 15 V.I.C. § 1041 *et seq.*, and the Restatement provisions dealing with the liability of a third person for the breach of trust of a fiduciary. *See* Restatement of Trusts (Second) § 321. Section 321 of the Restatement requires that in order for a third party to be liable for the misapplication of money by a trustee, that third party must have had notice that the trustee was misapplying the money. The Uniform Fiduciaries Act, in 15 V.I.C. § 1044, set forth an even stricter standard. That provision requires either actual knowledge of a breach of duty on the part of fiduciary or knowledge of such facts that would render taking a negotiable instrument from the fiduciary an act of bad faith.

Had this Court based its imposition of liability on Citibank on an alleged participation in or knowledge of the breach of trust by the bank, these provisions might have worked to relieve the bank of liability. For, I do not believe the facts support either knowledge of Joy's intended breach or bad faith on the part of Citibank or BNS. Liability is rather based on the issuance by Citibank of a CD to Joy personally, in the face of unambiguous instructions, derived from both the endorsement on the $115,211.00 check and the CD application form, to issue the certificate to Joy as a receiver of Quantum. *See* Restatement of Trusts (Second) § 324, comment e; Bank of Giles County v. Fidelity and Dept. Co., *supra;* Duckett v. National Mechanics' Bank, *supra;* 5A Michie, Banks & Banking § 57b, at 172.

JUDGMENT

In accordance with the foregoing Memorandum Opinion and the reasons set forth therein, it is hereby

ORDERED, ADJUDGED and DECREED:

1. That plaintiff American Fidelity Fire Insurance Company be paid by defendant Bank of Nova Scotia the

sum of $77,664.54, plus interest thereon at the rate of 6% per annum from from October 2, 1973 to July 1, 1975 (the date on which the amendment to 11 V.I.C. § 951 becomes effective), and 9% per annum from July 1, 1975 to the date of this Judgment.

2. That plaintiff American Fidelity Fire Insurance Company be paid by defendant First National City Bank the sum of $117,571.51, plus interest thereon at the rate of 6% per annum from November 19, 1973 to July 1, 1975, and 9% per annum from July 1, 1975 to the date of this Judgment.

3. That plaintiff American Fidelity Fire Insurance Company be indemnified by defendants Bank of Nova Scotia and First National City Bank for costs and attorneys' fees incurred by it in this action.

Be it further ORDERED:

That pursuant to the procedures established by the Third Circuit in Lindy Bros. Bldrs., Inc. v. Am. R. & S. San. Corp., 487 F.2d 161 (3d Cir. 1973), and Estien v. Christian, 507 F.2d 61 (3d Cir. 1975), counsel for AFFIC shall set forth in affidavits the number of hours expended in the preparation of this litigation, their normal billing rates, the contingent nature of recovery in this action, the complexity of the issues, etc. Counsel shall pay special attention to the relative allocation of time and effort as between the BNS and Citibank proceedings. If, following the submission to the Court of the foregoing affidavits, the defendants have any objections to the facts as stated therein, they may request either an adversary hearing on the issue of attorneys' fees or submit the issue to the Court on written memoranda. Said objections shall be

submitted to the Court within ten (10) days of the filing of the affidavits of plaintiff's counsel.

Dated this 24th day of July, 1975.

Enter:

Warren H. Young
WARREN H. YOUNG
Judge

ATTEST:

LEO PENHA
LEO PENHA, Clerk of the Court

Appendix C.

Bankruptcy Act § 47(a), 11 U.S.C. § 75

Trustees; duties

(a) Trustees shall (1) collect and reduce to money the property of the estates for which they are trustees, under the direction of the court, and close up the estates as expeditiously as is compatible with the best interests of the parties in interst; (2) deposit all money received by them in designated depositories initially in demand deposits; and subsequently, if authorized by the court, in interest-bearing savings deposits, time certificates of deposit, or time deposits-open account; (3) account for and pay over to the estates under their control all interests received by them upon funds belonging to such estate; (4) disburse money only by check or draft on such depositories; (5) keep records and accounts showing all amounts and items of property received and from what sources, all amounts expended and for what purposes and all items of property disposed of; (6) set apart the bankrupts' exemptions allowed by law, if claimed, and report the items and estimated value thereof to the courts as soon as practicable after their appointment; (7) examine the bankrupts (a) at the first meetings of creditors or at other meetings specially fixed for that purpose, unless they shall already have been fully examined by the referees, receivers, or creditors, and (b) upon the hearing of objections, if any, to their discharges, unless otherwise ordered by the court; (8) examine all proofs of claim and object to the allowance of such claims as may be improper; (9) oppose at the expense of estates the discharges of bankrupts when they deem it advisable to do so; (10) furnish such information concerning the estates of which they are trustees and their administration as may be requested by parties

in interest; (11) pay dividends within ten days after they are declared by the referees; (12) report to the courts in writing the condition of the estates, the amounts of money on hand, and such other details as may be required by the courts, within the first month after their appointment and every two months thereafter, unless otherwise ordered by the courts; (13) make final reports and file final accounts with the courts fifteen days before the days fixed for the final meetings of the creditors; and (14) lay before the final meetings of the creditors detailed statements of the administration of the estates.

Bankruptcy Act § 61, 11 U.S.C. 101

Depositories for money

The judges of the several courts of bankruptcy shall designate, by order, banking institutions as depositories for the money of estates under this title, as convenient as may be to the residences of receivers and trustees, and shall require from each such banking institution a good and sufficient bond with surety, to secure the prompt repayment of the deposit. Said judges may, in accordance with the provisions of, and the authority conferred in section 15 of Title 6, accept the deposit of the securities therein designated, in lieu of a surety or sureties upon such bond and may, from time to time as occasion may require, by like order increase or decrease the number of depositories or the amount of any bond or other security or change such depositories: *Provided,* That no security in the form of a bond or otherwise shall be required in the case of such part of the deposits as are insured under section 1821 of Title 12: *And provided further,* That depository banks shall place such securities, accepted for deposit in lieu of a surety or sureties upon depository bonds in the custody of Federal Reserve banks or branches thereof designated by the judges of the

several courts of bankruptcy, subject to the orders of such judges. All national banking associations designated as depositories, pursuant to the provisions of this section, are authorized to give such security as may be required. All pledges of securities heretofore made for the purposes herein named are ratified, validated, and approved.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 1732-75

In the Matter of
QUANTUM DEVELOPMENT CORPORATION,
Debtor.

FIRST NATIONAL CITY BANK,
Petitioner,

v.

AMERICAN FIDELITY FIRE INSURANCE COMPANY,
CHARLES JOY, RECEIVER,
CHARLES TAIT, TEMPORARY RECEIVER,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF RESPONDENT AMERICAN FIDELITY FIRE INSURANCE COMPANY IN OPPOSITION TO PETITION

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New York, N.Y. 10017

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases Cited

STATUTES CITED

OTHER AUTHORITIES

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Opinions Below

The opinion of the Court of Appeals is not reported. The opinion of the District Court is reported at 397 F. Supp. 329 (D.V.I., 1975).

Jurisdiction

The judgment of the Court of Appeals was entered March 24, 1976.

Petitioner's petition for rehearing and for rehearing en banc was denied by the Court of Appeals April 21, 1976.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Question Presented

Where a bank which has not been designated as an authorized depository for bankruptcy funds by the District Court under whose supervision a bankruptcy receiver is acting accepts from such receiver funds which the bank knows are bankruptcy funds and in exchange gives him a certificate of deposit in his individual name, upon the maturity of which it transfers the proceeds outside the jurisdiction to his individual credit, is the bank liable as trustee *ex maleficio* to account for the return of the funds to the bankruptcy estate?

Statute Involved

The statutory provisions involved are Sections 47(a) and 61 of the Bankruptcy Act, 11 U.S.C. §§ 75(a), 101, which are set forth in Appendix C to the petition.

Statement

Respondent American Fidelity Fire Insurance Company accepts petitioner's statement (pet., pp. 2-5), subject to the following corrections and additions.

1. The order of April 13, 1973 directing the receiver to deposit the sum of $115,211 was not made by the "district court, sitting as a bankruptcy court" (pet., p. 3) but by Hon. Rafael Rivera Cruz (JA 2 # 16),* then Referee in Bankruptcy (PA 6a, ftn. 3), although sometimes called "Bankruptcy Judge" (PA 23a).

2. The application for the certificate of deposit signed by Joy requested that the certificate of deposit be issued in favor of "Charles R. Joy, Receiver" (JA 29). It was in fact issued in favor of "Charles R. Joy" (JA 31).

3. We disagree with petitioner's claims that it had no notice Joy intended to abscond and that "there is no suggestion that any inquiry, however searching, would have uncovered this foul purpose" (pet., p. 4). When petitioner transferred the funds to Miami, it knew:

> (a) That the funds were bankruptcy funds. (This is apparent from the face of the $115,211 check [JA 30].)
>
> (b) That the funds were being held pending the further order of the bankruptcy court. (That is what was provided in the order of April 13, 1973 [JA 36] referred to on the face of the check.)
>
> (c) That there could be no possible reason for sending the funds out of the Virgin Islands to Joy's individual credit. (As noted in the petition [p. 3], Quantum had been engaged in construction in the Virgin Islands. Any off-island creditors could and should have been paid by check.)
>
> (d) That the amount involved was extraordinarily large, particularly for a person in Joy's economic status. (Petitioner's own records showed he was chief engineer of a hotel [JA 32] who requested that his charge limit be increased to $1000 [JA 34].)

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* References preceded by "JA" are to the Joint Appendix in the Court of Appeals; those preceded by "PA" to the Appendix to the petition herein.

Surely, it would not have taken a modern Sherlock Holmes to deduce from the foregoing that something foul was in progress.

Argument

Respondent respectfully submits (a) that certiorari is not warranted in this case and (b) that the decision of the Court of Appeals herein was correct.

(A) Certiorari Is Not Warranted

Over 32 years ago, on May 29, 1944, this Court denied, *First National Bank in West Union, West Virginia* v. *American Surety Company of New York,* 322 U.S. 754, a petition to review the decision of the Court of Appeals for the Fourth Circuit, *American Surety Company of New York* v. *First National Bank in West Union, West Virginia,* 141 F2d 411 (1944), holding that a bank which, though not designated to accept bankruptcy funds, knowingly accepts such funds becomes liable as a trustee *ex maleficio.* In that case, the petitioning bank (pet., pp. 24-31) cited, to show a conflict, the decisions of the Sixth and Seventh Circuits relied on by petitioner herein, *Irving Trust Co.* v. *United States,* 83 F2d 20 (CA6, 1936), *cert. den.* 298 U.S. 686 (1936); *In re Bogena & Williams,* 76 F2d 950 (CA7, 1935).

During the intervening years, at least so far as the reported cases reveal, the problem did not arise until the instant case. The reason is not hard to understand. For such a problem to be presented it is necessary both (1) that a non-designated bank knowingly accepts bankruptcy funds and (2) that either (a) the fiduciary embezzles the funds or (b) the bank fails and the amounts involved exceed the limit of FDIC insurance, 12 U.S.C. § 1821. Fortunately, it is very rare that both these requirements are satisfied in a single case, particularly with the advent of FDIC.

Since the question of the liability of non-designated depositories appears to occur only once every thirty years, it is not the sort of conflict among Circuit Courts of Appeals, assuming there is a true conflict, that requires the attention of this Court. It does not concern an important question nor one likely to produce continuing consequences in the foreseeable future.

Furthermore, a resolution of the alleged conflict would not terminate this case. The District Court decided against petitioner on an entirely different ground from the alleged conflict, to wit, because of the issuance by petitioner of the certificate of deposit to Joy personally "in the face of unambiguous instructions" to issue it to him as receiver (PA 33a). The Court of Appeals did not reach this question (PA 17a). Therefore, were the petition to be granted and the judgment of the Court of Appeals reversed, it would be necessary to remand the case to the Court of Appeals for consideration of the question it did not reach, followed perhaps by another petition to this Court. Such prolongation of litigation is not warranted to resolve an alleged conflict on a matter of negligible practical consequence.

Finally, it is respectfully submitted that there is no true conflict between the decision of the Third Circuit herein and that of the Fourth Circuit in *American Surety Company of New York* v. *First National Bank in West Union, West Virginia, supra,* on the one hand and those of the Sixth and Seventh Circuits in *Irving Trust Co.* v. *United States, supra,* and *In re Bogena & Williams, supra.* In the two former cases the banks remained solvent and the consequences of holding them trustees *ex maleficio* fell on them whereas in the latter two cases the banks failed and the consequences would have fallen on their depositors. The concept of constructive trusts is of equitable origin, see *Healy* v. *Commissioner of Internal Revenue,* 345 U.S. 278, 282 (1953), and it is not inequitable to consider the

consequences of a decision and to avoid the punishment of innocent persons.

The Court of Appeals for the Sixth Circuit concluded its opinion in *Irving Trust, supra,* after pointing out that the bankruptcy trustee could have required a bond from the bank, by stating: "It would be inequitable to require the repayment to it [the bankruptcy trustee] of the balance in its account at the time the bank closed in preference to the claims of others who similarly failed to require bonds to protect their deposits" (83 F2d at 24-25). The Court of Appeals for the Fourth Circuit in *American Surety, supra,* said of *In re Bogena & Williams, supra,* and *Irving Trust, supra:*

> ". . . we do not think that they should control our decision here. They were concerned, not with the liability of the bank to the bankrupt estate, but with the right of the estate to preferential treatment in distribution of assets of banks which had become insolvent, and the effect of the decisions was to place the claims of the bankrupt estates on an equal basis with other depositors." (141 F2d at 414-415).

Finally, this distinction was recognized by the Court of Appeals for the Third Circuit herein (PA 12a, ftn. 14).

The net result of the four cases is that a bankruptcy estate whose funds are deposited in a non-designated bank may hold the bank liable as a trustee *ex maleficio* but has no priority over other depositors in case of the failure of the bank. Such a rule is reasonable and equitable and, since the result of all four cases is consistent with it, shows that there is no real conflict.

(B) The Decision of the Court of Appeals was Correct

Petitioner does not claim that any of its branches in the Virgin Islands had ever been designated by a Judge of the District Court of the Virgin Islands as depositories

pursuant to Section 61 of the Bankruptcy Act, 11 U.S.C. § 101.

It makes no difference that a District Judge in Puerto Rico had designated petitioner's branches there, for a designation is effective only as to estates administered in the District in which the District Judge sits. *Irving Trust Co.* v. *United States, supra,* 83 F2d at 22. The instant bankruptcy proceeding is, of course, being administered in the District Court of the Virgin Islands.

It also makes no difference that, on September 10, 1973, when petitioner's Christiansted branch received the check and issued the certificate of deposit in Joy's individual name, no other bank in the Virgin Islands had been designated as a depository for bankruptcy fund.* Joy, or his counsel, could have applied to one of the District Judges in the Virgin Islands to make such a designation.

Finally, it makes no difference that Referee Rafael Rivera Cruz in the order of April 13, 1973 directed Joy to deposit the funds "in a separate, interest-bearing account" (JA 36). This cannot be deemed the equivalent of a designation of whatever bank Joy might select, for a variety of reasons, the most important of which is that at the time of the order and at the time petitioner received the check, no Referee in Bankruptcy had power to designate a depository. That power was then vested under Section 61 of the Bankruptcy Act, 11 U.S.C. § 101, in the District Judges.** The Referees did receive such power under Rule 512(a) of the new Bankruptcy Rules, but those

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* It is of interest to note that a similar plea was made in the unsuccessful petition for certiorari in *First National Bank in West Union, West Virginia* v. *American Surety Company of New York, supra,* at page 33 of which it was stated: "There was no such depository at all in Doddridge County, where Petitioner's bank is located."

** Referees were specifically excluded from the definition of "Judge", Bankruptcy Act, § 1(20); 11 U.S.C. § 1(20).

Rules did not take effect until October 1, 1973 as to ordinary bankruptcies and until July 1, 1974 as to Chapter XI proceedings. Quantum was in Chapter XI until November 30, 1973, when it was adjudicated bankrupt. Furthermore, before a designation becomes effective, a bond must be filed by the bank, *In re Potell,* 53 F2d 877, 878 (E.D., N.Y. 1931), as required by Section 61. Referee Cruz's order, of course, makes no reference to a bond and it is not claimed that petitioner filed one in the Virgin Islands.

It is thus clear that the Christiansted branch of petitioner was not a designated depository on September 10, 1973. General Order 53(5) then provided that "No receiver . . . shall deposit with any one depository funds . . . in excess of the amount of the bond of such depository then in force". This General Order applied to Chapter XI proceedings, General Order 48(2). Section 47(a) of the Bankruptcy Act, 11 U.S.C. § 75(a), also applicable to Chapter XI proceedings, Section 302 of the Bankruptcy Act, 11 U.S.C. § 802, provides that "Trustees shall . . . (2) deposit all money received by them in designated depositories . . ." Accordingly, Joy had no right to deposit the funds of the estate with petitioner.

Such illegal deposit makes clearly applicable *Restatement (Second) of Trusts,* § 324, comment b (1957), quoted at the top of PA 13a, stating that a bank which accepts a deposit from a fiduciary with notice or knowledge that such deposit is forbidden is chargeable as a constructive trustee of the funds.

Notice that the funds were bankruptcy funds was given petitioner by the face of the check (JA 30). The illegality of the deposit is a matter of law, of which petitioner is presumed to have knowledge and with notice of which it is chargeable.

Federal Crop Insurance Corporation v. *Merrill,*
332 U.S. 380, 384 (1947);

Anderson National Bank v. *Luckett,* 321 U.S. 233, 243, 244 (1944);
IV Scott on *Trusts* (3d Ed., 1967), § 324.1.

The consequences of being a constructive trustee are not a mere liability for damages. He is liable to the beneficiary except to the extent the trust estate has received the benefits of any payments he has made.

Restatement (Second) of Trusts, § 291(3) and Comment o thereto;
Fidelity & Deposit Co. of Maryland v. *People's Bank,* 44 F2d 19, 20-21 (CA8, 1930), *cert. den. sub nom. People's Bank* v. *Fidelity & Deposit Company of Maryland,* 282 U.S. 901 (1931);
Central Stock & Grain Exchange of Chicago v. *Bendinger,* 109 Fed. 926 (CA 7, 1901), *cert. den.* 183 U.S. 699 (1901).

In *Fidelity & Deposit, supra,* it was said:

"In the instances where the banks received from the county treasurer county funds and placed them on deposit when they were not legal county depositories, they became trustees ex maleficio. Merchants' Nat. Bank v. School Dist. (C.C.A.) 94 F. 705; Bd. of Comm'rs v. Strawn (C.C.A.) 157 F. 49, 15 L.R.A. (N.S.) 1110; U.S.F. & G. Co. v. Union Bk. & Tr. Co. (C.C.A.) 228 F. 448; American Sur. Co. v. Jackson (C.C.A.) 24 F. (2d) 768; Fiman v. State of South Dakota, 29 F. (2d) 776 (C.C.A.8); Compton v. Farmers' Tr. Co., 220 Mo. App. 1081, 279 S.W. 746. As such their absolute liability could be relieved only by restoring the funds to the county. The banks in becoming trustees ex maleficio lost their right to presume that the county treasurer in withdrawing the funds would make proper disposition thereof. Perry on Trusts (7th Ed.) vol. 1, § 245; Central Stock &

Grain Exchange v. Bendinger (C.C.A.) 109 F. 926, 56 L.R.A. 875; U.S.F.&G. Co. v. People's Bank, 127 Tenn. 720, 157 S.W. 414; Glasgow v. Nicholls, 124 Wash. 281, 214 P. 165, 168, 35 A.L.R. 419." (44 F.2d at 20-21).

The foregoing authorities dispose of petitioner's claim, twice made on page 6 of the petition, that the Court of Appeals herein fashioned a "novel" rule. *Fidelity & Deposit, supra,* answers petitioner's efforts (pet., pp. 8-9) to distinguish the public funds cases cited by the Court of Appeals on the ground that in those cases the banks failed. The banks involved in *Fidelity & Deposit, supra,* appeared to have remained solvent at the time of the decision of the Court of Appeals; the litigation was against the banks and not their liquidators.

Petitioner's attempt (pet., p. 10) to explain away the decision of the Court of Appeals for the Fourth Circuit in *American Surety, supra,* ignores the plain language of the opinion in that case. Petitioner states (p. 10): "The breach of trust resulting in liability to the bank was not the acceptance of the unauthorized deposit . . ." Judge Parker, writing for the unanimous Court of Appeals, repeatedly stated that it *was* the acceptance of the deposit with knowledge that bankruptcy funds were involved that made the bank liable as trustee *ex maleficio.* See 141 F2d at 413, 414, 415, 416, 417. The *American Surety* case is indistinguishable from the instant one, and, just as the bank there involved was not released from liability although the trustee individually and his wife "gradually checked out by checks" the funds in question (141 F2d at 412), so the fact that Joy individually received all the funds involved herein is no defense. The test is whether the funds were restored to the estate, *American Surety, supra,* 141 F2d at 417; *Fidelity & Deposit, supra,* 44 F2d at 20.

The fact that the Referee in Bankruptcy directed Joy to deposit the funds in an interest-bearing account is no

defense available to petitioner. In *Allen* v. *United States,* 285 Fed. 678, 681 (CA1, 1923), a bank which accepted without statutory authority deposits of post office funds from the Superintendent of one of the Boston postal stations was held liable as trustee *ex maleficio* despite the fact that the deposits had been made with the knowledge and consent of the Boston Postmaster. In the instant case the Referee had no authority to authorize Joy to violate the Bankruptcy Act. Furthermore, no violation of law was needed for Joy to comply with the Referee's order; Joy could have had a depository designated by a District Judge.

There is no basis for petitioner's claim (pet., p. 8) of a "windfall" for creditors of the bankrupt resulting from the decision below. No claim can be made that any creditor will receive more than he would have received if petitioner had properly handled the proceeds of the $115,211 check, which it might have done if its Christiansted Branch had been designated and the personnel of that branch had been instructed how bankruptcy accounts should be maintained. Far from a "windfall", there has been the expense of litigation all the way to this Court.

Petitioner speaks of the rule adopted by the Court of Appeals as "punitive in character" (pet., p. 6). We respectfully submit that the rule is no more penal than any other application of the doctrine of constructive trust and that it is sound public policy since it provides a meaningful sanction for the requirements of Sections 47(a) and 61 of the Bankruptcy Act, 11 U.S.C. §§ 75a, 101.

Furthermore, we respectfully submit that petitioner is in no position to complain of being held liable as a constructive trustee. It would have suffered no loss if it had followed normal banking practices. Advised from the face of the check (JA 30) that the funds it received were bankruptcy funds paid pursuant to a specified court order, which order said that the funds were to be held pending

further judicial determinations (JA 36), it carelessly, if not corruptly, issued a certificate of deposit in the individual name of the receiver and two months later transferred, without judicial sanction, the funds to his individual credit in Miami (PA 5a, 24a). Had it refrained from taking these two wholly indefensible steps, the funds would have remained in petitioner's possession available for delivery to Joy's successor as receiver or trustee and the question of its liability for accepting a deposit when not designated would have been totally academic.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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